

# Leave Less to the IRS (and the Lawyers)

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You've worked hard to build your assets—your investments, your home, your treasured possessions—and to provide a level of financial security for your loved ones. Doesn't it make sense to work just as hard to protect those assets for your heirs?

That's the primary goal of estate planning—to protect, preserve and manage your estate if you die or become disabled. Some people see no need for estate planning until they reach a certain age. Others believe that it's only for the wealthy. But in truth, it's wise for everyone to start the estate planning process as early as possible.

Without an estate plan, the fates of your assets and your loved ones may be decided by attorneys or the government. The state could decide who will care for your minor children. Taxes and legal fees could eat away at your estate, and distribution of your assets could be delayed at a time when your heirs need them most.

So why doesn't everyone have an estate plan? Aside from a natural reluctance to face our own mortality, some people are put off by the belief that estate planning will be complicated, time-consuming and costly. But setting up an estate plan doesn't have to be complex.

Estate planning can begin with something as simple as updating the beneficiaries of your insurance policies and retirement accounts. It may involve adding one or more heirs as co-owners of your home, bank and brokerage accounts, or other assets. To make sure all of your wishes are carried out, you'll need to draft a will and perhaps establish one or more trusts, but even these activities can be handled in a few brief meetings with an estate attorney.

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## Why you need an estate plan

It lets you accomplish these crucial objectives:

- Ensure that your assets go to the people you choose, not those the state chooses.
- Specify who will care for your minor children.
- Defuse potential family conflicts over your assets.

- Minimize estate taxes and other transfer taxes.
- Avoid the costs, publicity and delays of probate.
- Help ensure that you and your affairs will be taken care of as you wish if you become incapacitated.

Even if your estate is modest, take care of the basics:

- Tell loved ones where to find your documents and a list of your accounts, assets and insurance policies.
- Draft a will and final letter of instructions.
- Establish durable powers of attorney and health care in case you're incapacitated.
- Update your account titling and beneficiaries.
- Consider funding a revocable living trust with your titled assets along with a "pour-over" will to ensure other assets avoid a costly probate process.

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## Get started!

Most people can meet their estate planning goals with the simple, four-step process outlined below.

1. **Take inventory of your assets and liabilities.** List the value of your home and other real estate, cars, jewelry, artwork and other physical assets. Gather recent statements from your bank and brokerage accounts. Make a list of all insurance policies, their cash values and death benefits. Finally, list all liabilities, including mortgages, lines of credit and other debt.
2. **Define your estate planning goals.** To whom do you want your assets distributed, and in what proportions? If these heirs aren't living at the time of your death, whom do you wish to name as successor beneficiaries? Whom do you want caring for your minor children? What do you want to put aside for your children's ongoing care and education? Who should manage your affairs if you become disabled, and distribute your assets upon your death? Who will make health care decisions on your behalf if you become incapacitated? Answering these questions before you meet with an estate planner can save you both time and money.
3. **Have an estate planning attorney draft your documents.** Laws regulating estate settlement vary from state to state, so we strongly recommend that you meet with an experienced attorney to prepare your estate plan. A qualified attorney will review your objectives and explain the tools—wills, trusts, powers of attorney and more—you can use to help accomplish your goals. Many of these documents are fairly standard in format, which can substantially reduce the cost of developing your plan.
4. **Follow through on your plan.** If you set up a trust, fund it promptly. If you fail to do so, the agreement won't take effect, and your assets may not pass to your beneficiaries as you'd intended.

## Consider these smart strategies

### Start by transferring wealth in your lifetime

Lifetime gifts are generally better than testamentary gifts when transferring wealth. Think of it this way: Picture four quarters on the table in front of you. If you die with all four quarters, your heirs are left with two quarters and the federal government gets the other two. Instead, move two quarters aside, representing a lifetime gift to your loved ones. Now, take 50% of your remaining two quarters, or one quarter, and move it to the other side of the table as the gift tax you would owe. Look—you've still got a quarter left!

Currently, you can give up to \$12,000 each to any number of persons in a single year without incurring a taxable gift (\$24,000 for spouses "splitting" gifts). You

can give away a total of \$1 million during your lifetime before any out-of-pocket gift tax is due.

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**Tip:** Make unlimited payments directly to medical and educational providers on behalf of your loved ones, and preserve your \$1 million lifetime exemption.

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The lucky recipient of the gift owes no gift tax or income tax. Your treat is seeing the enjoyment of your gift, plus transferring future appreciation on the gift to the beneficiary, outside your estate.

Here are a couple of things to remember about lifetime gifting:

- **Leave yourself enough to live on.** The gift has to be irrevocable, so don't give until it hurts. Plan carefully with a tax professional.
- **Stay up on the law.** If the estate tax is repealed in the future, you may regret having paid gift tax now in an effort to minimize your estate tax. Do the best you can based on what you know now.

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Keep these basics in mind

- **Don't be seduced by what someone else did.** It's your estate, so begin and end with your personal goals.
- **Use a qualified estate planner** who's up-to-date on the latest statutory, regulatory and judicial developments. Or consider combining a CPA (for tax-efficient strategies) with an estate planning attorney (to draft the legal documents).
- **Be wary of strategies that seem too good to be true**, such as big valuation discounts or "tax-free" offshore deals.

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## To take care of your surviving spouse

Typically, spouses will use a credit shelter (bypass) trust to preserve the first-to-die's estate tax exemption. Assets beyond that estate tax credit can pass to the surviving spouse outright, or via a marital trust, without any current estate taxation (for U.S. citizens).

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### Simple Strategies to Consider

If the strategies in this article seem too complex or aren't a good fit for your needs, here are some everyday financial planning ideas with attractive estate planning kickers.

#### Convert to a Roth to reduce (or create) your estate

For those who qualify (adjusted gross income of \$100,000 or less in the year of conversion), converting all or part of a traditional IRA into a **Roth IRA** could be a useful estate planning technique—if you think you won't need your traditional IRA for your own expenses.

Although your Roth will still be included in your gross estate, there are no required minimum distributions, allowing the account to grow larger than it otherwise might under the traditional IRA rules. Also, your heirs will be able to take withdrawals free of income tax.

What's more, the income tax you pay on conversion (preferably from assets other than the IRA) will reduce your gross estate. In effect, you're making a gift by prepaying the income tax on behalf of the beneficiaries without it really counting as a taxable gift.

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**Tip:** A Roth conversion is great for situations where there's no taxable estate, because those heirs would have no future income tax deduction available for previously paid estate taxes anyway.

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Even when a future deduction for estate taxes attributable to the inherited IRA would be available, there might still be some advantage to a Roth, primarily because the converted Roth would not be subject to minimum distributions during the original account holder's lifetime—and therefore the balance could potentially grow much larger. Obviously, this strategy requires some serious number crunching.

### **Reduce your overall estate with charitable gifting**

A **charitable** remainder trust (CRT) is primarily a diversification and income tax strategy, although the charitable gift component will have an impact on reducing your gross estate.

A testamentary charitable lead trust (CLT), on the other hand, is typically more appropriate for estate planning purposes, rather than as a lifetime income strategy. At death, a portion of your estate is placed into the testamentary CLT, reducing your gross estate. The charity you choose receives an annuity for a period of years. At the end of the term, your heirs receive the remainder interest.

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### **To take care of your spouse and children from a prior marriage**

With a qualified terminable interest property (QTIP) trust—the most flexible marital trust—the executor decides how much of the estate qualifies for the unlimited marital deduction. The surviving spouse's needs and expenses are still taken care of during his or her lifetime, but the eventual distribution of trust assets to the first spouse's children is protected. This trust is especially attractive for people with children from a prior marriage, or if there's concern over what might happen if a surviving spouse remarries.

### **To capitalize on a valuable home while you're still living there**

A qualified personal residence trust (QPRT) allows you to transfer a residence into a trust for gift purposes, while retaining the right to live there for a period of years. At the end of the term, the residence is transferred to the beneficiary.

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**Tip:** Use the QPRT strategy when interest rates are high, because a higher discount rate (determined by the IRS) means that the present value of the home subject to gift tax is lower.

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Here's what makes this strategy effective: For gift tax purposes, the transfer is calculated as the present value of the remainder interest. The right to stay in the house has value, which is deducted from the gift. What's more, any future appreciation after the transfer to trust is not included in the grantor's estate. The grantor may arrange to stay in the house at the end of the term at fair market rent. One caveat: The longer the term of the QPRT, the smaller the gift will be for tax purposes. But the grantor must outlive the trust's term or the home value will revert to the estate, so plan for that trade-off.

### **To minimize gift tax value**

With a grantor retained annuity trust (GRAT), the grantor transfers assets to a trust for a relatively short period of years. During the term, the grantor receives an annuity from the trust. At the end of the term, the remaining assets pass to the beneficiary.

The annuity payments reduce the gift's value for gift tax purposes; the value is determined at the time of transfer into the trust. As long as the assets in the trust outperform the discount rate (or hurdle rate), this can be an extremely effective transfer strategy.

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**Tip:** Use a GRAT in a low-interest-rate environment because the assets have a better chance of beating the hurdle rate. GRATs also work especially well with assets currently depressed in value but with the potential for significant appreciation.

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### **To have greater control over the time period of your gift**

In order for a gift to qualify for the annual \$12,000 exclusion, it must be a "present interest," not a "future interest." In other words, the recipient must be able to use or spend the gift immediately, with some exceptions for gifts to children.

The Crummey power trust (named for the taxpayer who first used the strategy) allows transfers to the trust to qualify as a present interest. Also, you can write in your own rules about when and how the beneficiary ultimately receives control of the assets.

The beneficiary of a Crummey power trust gets a limited period of time during which he or she can withdraw the annual gift from the trust, after which the gift becomes subject to the provisions and terms of the trust. As long as this "Crummey power" is available, whether or not it's exercised, the gift creates a present interest and qualifies for the grantor's annual gift tax exclusion. Of course, if the beneficiary wants the grantor to continue funding the trust, he or she typically does not exercise the power. (If the grantor wanted the beneficiary to spend the money now, why create a trust?) Crummey powers are often used with irrevocable life insurance trusts (below).

### **To transfer wealth from an illiquid business or real estate**

Life insurance is often used in estate planning to provide liquidity in the case of closely held or hard-to-sell assets (a family business, family farm, significant real estate holdings, etc.) or as a wealth replacement vehicle to provide for family members in the face of estate tax liabilities or charitable bequests.

However, though life insurance proceeds are generally income tax free to the beneficiary, they're included in the decedent's gross estate as long as the decedent owns the policy. The most effective way to avoid this problem is with an irrevocable life insurance trust. As long as the trust owns the policy, the proceeds are outside the estate and will pass free of both income and estate taxes.

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**Tip:** Have your irrevocable life insurance trust purchase your life insurance policy, because the transfer of an existing policy within three years of death will bring the proceeds back into the estate.

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### **To maintain family assets and relationships**

A family limited partnership (FLP) can be an effective way to manage and control family assets while providing for the tax-effective transfer of wealth to others. In the typical arrangement, mom and dad gift the majority of the partnership to family members in the form of limited partnership interests. Because limited partners have no say in running the partnership and usually can't sell or borrow against their interests, valuation discounts arising from lack of liquidity and marketability will apply for gift tax purposes. Additional valuation discounts may apply to the assets themselves (for illiquid small business or undivided interests in real estate, for example).

Structured correctly, FLPs can be a valuable planning tool. However, overly aggressive structures that seek unreasonable valuation discounts or run afoul of the rules in some other respect may invite unwanted scrutiny from tax authorities. For this reason, it's very important to work with a reputable expert when considering a family limited partnership.

## Finally, don't get paralyzed waiting for estate tax repeal

Although the estate tax is set to expire in 2010, under current law it comes back in 2011 in all its pre-2001 glory (see table below). Many of your estate planning decisions will depend on what you think Congress might do down the road.

That's anyone's guess, of course. We could revert back to the old law, or permanent repeal could become a reality. Or we could end up with something in the middle—higher limits for taxable estates. As frustrating as the uncertainty might be, the best you can do is plan based on what you know now. Remember, any guess about the future is still just a guess, and the law as it stands is still the law.

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Estate and Gift Tax: 2008-2011				
	Estate Tax		Gift Tax	
	Highest Rate	Exemption	Highest Rate	Exemption
2008	45%	\$2,000,000	45%	\$1,000,000
2009	45%	\$3,500,000	45%	\$1,000,000
2010	0%	Repeal	35%	\$1,000,000
2011	55%	\$1,000,000	55%	\$1,000,000

Again, we've highlighted just a few of the many estate planning ideas available. As you consider these and other transfer strategies, be sure to work with trusted professionals who can help you put together an estate plan based on your particular needs and goals.

### Important Disclosures

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